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# Journal of International Money and Finance

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## Grand corruption instead of commitment? Reconsidering time-inconsistency of monetary policy

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### A B S T R A C T

#### JEL classification:

E52  
E58  
E61  
E62  
H39

#### Keywords:

Monetary policy  
Fiscal policy  
Inflationary bias  
Deficit bias  
Expropriation  
Political economy

This paper suggests that inflation may be affected differently by grand corruption compared to its positive nexus with petty corruption. In an extended Barro and Gordon (1983a) model grand corruption may serve as a quasi-commitment device: a cheating (expropriating) government may actually deter a monetary authority from cheating (reneging). Furthermore, Rogoff's (1985) conservative central banker has an unambiguously beneficial effect; she reduces the inflationary bias even more while also rendering fiscal policy more effective. The model nests the standard fiscal–monetary interaction logic with and without expropriation as well as the diametrical “symbiosis” result obtained by Dixit and Lambertini (2003a).

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### 1. Introduction

What is the nexus between corruption and inflation? Theory and empirical evidence suggest that there may be a positive effect of petty corruption on inflation, but not much is known about the impact of grand corruption on inflation. As for empirical evidence, there seems to be some indication of a positive link, overall, although the body of literature is sparse, for instance Al-Marhubi (2000) and Smith-Hillman (2007).<sup>1</sup> A conceptual problem is that empirical studies do not take account of the

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<sup>1</sup> Al-Marhubi (2000) finds strong evidence for a positive relationship with data averaged over 15 years. Smith-Hillman (2007) studies inflation and corruption in African and industrial economies. She also finds a positive relationship, but it is only significant when both country groups are combined, not when each group is studied separately. Furthermore, all empirical results must be viewed with caution due to criticism of the available corruption variables discussed in the literature, in particular the fact that all corruption indices only measure subjective perceptions.

difference between petty corruption on the one hand, and grand corruption (henceforth also called expropriation) on the other hand.<sup>2</sup> In fact, the corruption indicators used typically capture petty corruption.<sup>3</sup> From a theoretical point of view the effects of petty corruption and grand corruption may well be very different.<sup>4</sup> If petty corruption leads to tax evasion and firms going underground, then policymakers may find it optimal to lean towards higher inflation taxation. This is also the model-theoretic argument employed by Huang and Wei (2006) who contend that monetary policy should be allowed to be more expansionary, if there is a great deal of administrative inefficiencies (or petty corruption).

Based on a similar framework, but modelling grand corruption instead of petty corruption, this paper allows for the opposite result; government expropriation could even lead to lower inflation. It is argued that grand corruption may actually produce better monetary policies, if fiscal policymakers are known to attribute some (though possibly limited) value to expropriating the public. Given such an objective, the government determines its optimal level of output expansion (equality of marginal gain from output stimulation and the marginal gain from expropriation) and uses all additional resources for direct expropriation. If the central bank were to go for more output expansion by producing a higher surprise inflation, the government would like to withdraw its output-enhancing fiscal stimuli and use them for expropriation instead. Thus, an equilibrium with lower inflation than in the non-expropriation setting is possible, if not likely.<sup>5</sup>

The time-inconsistency problem of monetary policy and the exploitation of the short-run Phillips curve have first been studied by Kydland and Prescott (1977). The argument is that the central bank can renege on its promise of stable monetary policy and use surprise inflation (leading to lower real wages) for reducing unemployment below the natural rate of unemployment.<sup>6</sup> Anticipating agents render the government's machinations ineffective despite increased inflation. Barro and Gordon (1983a, b) argue that a commitment device is required for preventing such deviating policies, restoring private agents' trust in the policymaker, and thus ensuring an optimal outcome. Rogoff (1985) posits that an independent, inflation-averse ("conservative" in his terminology) central bank can establish a reputation for non-inflationary monetary policy and thus act as such a commitment device. Other commitment devices are central banker contracts – suggested by Persson and Tabellini (1993) and Walsh (1995) – and inflation targets – suggested by Svensson (1997) and discussed by Beetsma and Jensen (1999). Mishkin and Westelius (2008) show that optimally determined inflation band targets can achieve almost optimal monetary policy while being more realistic than writing optimal inflation contracts and appointing a "conservative" central banker. Pegging the exchange rate is yet another commitment device. However, Aizenman and Glick (2008) argue that – given a large enough shock – any fixed exchange rate regime will collapse and produce great losses in welfare.

<sup>2</sup> Corruption can be defined as the individual's (illegal) attempt to reap private benefits from public office. Petty corruption or bribery refers to government employees. Grand corruption means that the leadership uses its policy setting power for obtaining some personal advantage. This can take very different forms, for instance directly expropriating government funds, creating revolving-door opportunities (i.e. employment offers after one's term in office), or facilitating nepotism (e.g. granting advantages to family members, planting them in responsible government or business positions, or allowing them the legal exploitation of an artificial scarcity such as a monopoly). This paper does not make a distinction on legal grounds with corruption being illegal and rent-seeking being the overarching concept including both legal and illegal activities. However, a distinction between petty and grand corruption is made because it matters from an economic point of view.

<sup>3</sup> Mauro's (1995) bureaucratic inefficiency index exclusively measures petty corruption, but also Transparency International or Business International indices largely relate to petty corruption.

<sup>4</sup> This could be the case, although model-theoretic analyses are still few and far between. To my knowledge, there is still no "systematic analysis of the effects of corruption and inflation" – as already remarked by Al-Marhubi in 2000.

<sup>5</sup> Conceptually, the argument is related to the general principle of second-best theory which says that an additional distortion may actually improve welfare in an imperfect world. More specifically, it refers to the "greasing the wheels" hypothesis first suggested by Leff (1964). The hypothesis claims that corruption being an additional distortion may actually improve welfare in a second-best world. Empirically, this has been rejected, for instance by Mauro (1995), but also received some support, for instance by Méon and Sekkat (2005). The argument made in this paper is not the same though, because the focus of this paper is on limiting the inflationary bias, not on improving societal welfare.

<sup>6</sup> Based on OECD data from 1964 to 2003, Doyle and Falk (2008) argue that the time-inconsistency of monetary policy may help explain US inflation, but not inflation rates by other countries, albeit being influenced by spillover effects from the US.

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